ASSOCIATION OF CONSULTING ACTUARIES

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Policy Group
Private Pensions and Arm's Length Bodies Directorate
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Via email to: pensions.investment@dwp.gsi.gov.uk

Dear Sinead and David

Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to the consultation on Investment Innovation and Future Consolidation.

The attached Appendix 1 includes our responses to the specific questions raised and Appendix 2 sets out brief details of the ACA, which is the representative body for consulting actuaries in the UK.

In brief, we welcome the continued drive towards consolidating smaller occupational DC schemes and largely agree with the various detailed proposals made throughout the consultation. We note however that there are already many asset classes that Trustees can choose to invest in and they could already invest in illiquid assets if they wished to do so, as some have. The proposals made will encourage investment in illiquid assets but there is, of course, no guarantee that occupational DC schemes will invest much more in these assets.

I hope these comments are of interest and would be happy to expand or clarify if this would be helpful.

Yours faithfully

Hugh Nolan

Hugh Nolan
Chair of DC Committee
On behalf of the Association of Consulting Actuaries Limited

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APPENDIX 1

1. We would welcome comments on the following proposals around reporting pension schemes' approach to investing in illiquid assets. We would also welcome any other proposals which use reporting to prompt consideration of illiquid assets.
   (a) Scope: 'Relevant schemes' (broadly, schemes offering money purchase benefits other than from AVCs alone) with 5,000 or 20,000 or more members (or alternatively £250m or £1bn assets to provide for money purchase benefits) would be in scope of the proposed requirement. Would an asset-based or a membership-based threshold be more proportionate and effective?
   (b) Reporting their policy: Schemes in scope would be required to explain their policy in relation to illiquid investments in their Statement of Investment Principles
   (c) Reporting their actions: Schemes in scope would be required to report annually on their main default arrangements' approximate percentage holdings in illiquid assets, and with a breakdown in holdings of the trustees' choosing.

We agree that a scope based on membership numbers could apply prematurely to schemes with initially smaller amounts of assets building up gradually. We believe that defining relevant schemes by asset size would be more appropriate to capture the target population. Schemes with very large numbers of members are likely to reach the asset threshold in due course anyway but we believe it would be disproportionate to force extra governance requirements onto such schemes before they accumulate sufficient assets to make it worthwhile to insist on a formal policy and reporting on investment in illiquid assets. The proposed requirements do not seem excessively onerous for a scheme with assets of at least £250m.

We welcome the proposal to require transparency in this area by including an explanation in the Statement of Investment Principles. This will allow schemes to invest flexibly in the most appropriate way, while also encouraging them to consider illiquid investment.

We also welcome the proposed annual reporting of the approximate holdings in illiquid assets, especially given the practical suggestion that schemes should have flexibility in both the level and categorisation of the breakdown.

2. Do you think Government should encourage or nudge smaller occupational DC pension schemes to consolidate? If this should only happen at some point in the future what factors should be taken into account in determining that point?

There is clear evidence that the best outcomes for members can be achieved in larger schemes with strong governance, well-designed investment strategies and lower costs from economies of scale. We are therefore broadly supportive of the continuing consolidation of smaller DC schemes and believe this will serve consumers well. However, we also agree that many smaller schemes have service providers, advisers and investment managers that can access significant scale and we would hope to see this recognised in policy making. Similarly, some smaller schemes are very well managed and provide excellent value and member outcomes and so we would prefer to see encouraged, rather than mandatory, consolidation.

3. We would welcome views on the following proposals around pension schemes reporting their position on the potential benefits of future consolidation, or any other associated proposals.
   (a) Scope: 'Relevant schemes' with fewer than 1,000 members (or alternatively less than £10m in assets to provide for money purchase benefits) would be in scope of the proposed requirement.
   (b) What should be reported: Schemes in scope could be required to explain their assessment of whether it would be in members' interests to be transferred into another scheme with significantly more scale. Should charges, investment, governance and administration all be compared? Is a reference scheme, or other guidance needed for comparison?
   (c) Reporting vehicle: The requirement could be added to the value for members assessment which forms part of the Chair's Statement and published annually.
   (d) Updating frequency: The explanation of whether it is in members' interests to consolidate should be updated at least every 3 years, and after any significant change in size or demographic profile.

We agree that consolidation is likely to be in the best interests of members of many smaller DC schemes and that it therefore makes sense to require such schemes to assess and report on this. We believe that the primary determining factor as to whether schemes should be in scope should be asset value rather than membership numbers and that £10m is an appropriate threshold for this test.

We believe that charges, investment, governance and administration do all need to be considered in assessing whether members would be better off being transferred into another scheme. In particular, we believe that any exit penalties or investment guarantees that could be lost on transfer should be considered as part of the assessment of charges and that the online access and functionality for members should be included as part of the administration considerations. We also believe that trustees should consider the level of engagement with members, including the standard, frequency and cost of communications, any bespoke arrangements in place based on specific member profiles or input and the proportion of members who are actively engaged. If the assessment concludes that a bulk transfer would be in members' best interests, there should be an additional requirement to explain what is being done to implement this (or why there is no such action being taken).

The annual Chair's Statement is the natural place for inclusion of the new information.

The suggestion of an update every 3 years is reasonable but could become a self-fulfilling prophecy by adding an unnecessary level of additional cost and an extra administrative burden, particularly for schemes where there may be a compelling and stable reason to maintain the status quo. We believe that this frequency could be extended to every 5 years without any likelihood of member detriment, given the proposed requirement to review after any significant change in size or demographic profile.

4. We note that there is no question 4 in the consultation request

5. **What do you think about the use of indicators such as trustee knowledge and understanding, open or closed status or member demographics to identify and encourage schemes to consider consolidation? What indicators do you recommend and how could they best be communicated and verified?**

There are existing requirements for adequate Trustee Knowledge and Understanding and powers for the Regulator to monitor and enforce these. We do not believe that the obligations to look after member funds diligently is affected by whether the scheme is open or closed. We do think that member demographics might be an important part of the assessment as to whether members would be better off transferring to a larger scheme but it would be practically difficult to set specific guidelines to capture this sensibly and proportionately so we believe it would be more appropriate to limit the identification of target schemes by the simple metrics of asset size and/or membership numbers, which are both easily communicated and verified.

6. **To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?**

Performance fees are very common in illiquid asset classes but we do not believe there is always a good reason why they should be required. Market practices are changing with increased transparency and ultimately this may well lead to downward pressure on fees. Given the very bespoke nature of many illiquid investment classes, fee competition can be quite limited and this can lead to difficulties with the charge cap.

7. **To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?**

Although it is perfectly feasible to access funds with a performance fee within the overall charge cap, we believe that the mechanism does inhibit this. The legal requirement for a charge below the cap can sometimes lead to an excessive focus on cost rather than value, with cheaper investment options favoured to generate a positive headline figure even if this may not lead to the optimal member outcome. The added complexity of a performance fee can further distort a comparison between funds, as well as frictional costs of monitoring and communicating these charges.

8. **Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?**

We do not foresee any reason why permitting the additional method of charges assessment should disadvantage members and therefore we not see any reason why the additional approach should not be permitted.

9. We propose that:

(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.
(b) We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.
(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees.

We agree that it is important that performance fees should be calculated and accrued on a continuous basis to ensure that the members who benefit from the performance are those that pay the corresponding fees. We also agree that the overall fee structure should be kept as simple as possible and therefore welcome the proposal to limit the charges that are permitted alongside a performance fee to exclude contribution charges and flat fees.

10. Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

Yes, we believe that the updated list provides increased clarity. I am not aware of any other areas where further clarity might be required.

11. We would welcome views and any estimated costing for the impacts of these proposals.
(a) Stating a policy on illiquid holdings
(b) Reporting on illiquid holdings.
(c) Considering and reporting on whether it might be in members' interests to consolidate
(d) The additional method of assessment with the charge cap.

[NB This question was labelled as a second Q10 in the Consultation.]

We believe that all these proposals would have limited cost implications. While there may be an initial cost for schemes to formulate a policy on illiquid holdings, we would anticipate that many of the schemes within the proposed scope would already have a relevant policy, even if this has not been formally documented. Similarly, we expect that schemes with illiquid holdings will naturally receive some reporting on these and that there will be a limited cost to collate it for the new reporting, given the proposed flexibility on exactly how to do so. The additional method of assessment with the charge cap need not be used by schemes and so would only be adopted by those who see a benefit of doing so, perhaps simply because it is easier and cheaper than the current methods. Fundamentally these costs are likely to be incurred only by larger schemes and the additional requirements can all be carried out at a very modest cost compared to the size of the assets held by these schemes.

The position is less clear when considering and reporting on whether it might be in members' interests to consolidate. A robust assessment of the benefits of transferring could easily cost in excess of £20,000 for even a relatively small scheme, particularly if there are complications such as with-profit funds and so on. This cost could be disproportionate, especially with frequent reviews being required, and there is therefore a risk that the assessments would be meaningless governance exercises rather than a genuine consideration of the potential benefits.

APPENDIX 2

About the Association of Consulting Actuaries (ACA)

Members of the ACA provide advice to thousands of pension schemes, including most of the country's largest schemes. Members of the Association are all qualified actuaries and all actuarial advice given is subject to the Actuaries' Code. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of private sector defined benefit pension schemes.

The ACA is the representative body for UK consulting actuaries, whilst the Institute and Faculty of Actuaries is the professional body.

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